No. 02-1112

Supreme Court, U.S.
FEB 26 2003

In The

Supreme Court of the United States

EDWARD D. JONES & CO., L.P. d/b/a
EDWARD JONES, AND PAUL HUSTED,

Petitioners,

v.

ALICE P. KLOSS,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Montana

RESPONDENT'S BRIEF IN OPPOSITION

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RESTATEMENT OF QUESTION PRESENTED

Does the Federal Aribitration Act pre-empt a State Court decision that undisclosed arbitration provisions are unenforceable under generally applicable principles of adhesion contract, fiduciary duty and contractual waiver of constitutional rights law?

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COUNTER STATEMENT OF THE CASE

Respondent is a 96-year-old widow. See Pet. App. 3. Compared to Petitioners, she had no bargaining power and was relatively unsophisticated. Pet. App. 18 and 23-24. Petitioners became Respondent's stockbrokers in 1989. Pet. App. 3. Over the next nine years, Respondent grew to trust Paul Husted and to rely on him to explain important terms in Petitioners' standard form contracts. Pet. App. 8-9. In opening accounts, Petitioners routinely explained important terms in their form agreements to investors. *Id.* Petitioners did not regard their arbitration provisions as significant and did not explain them. Pet. App. 8-9.

In 1998, Respondent opened another customer account with Petitioners pursuant to their investment advice. Pet. App. 3. Petitioners presented Respondent with a signature card which was detached from the document containing the arbitration terms. The card purported to incorporate by reference the arbitration provisions contained in the separate document. Pet. App. 3-4 and 20. At Petitioners' direction, Respondent signed the detached signature card before she was provided a copy of the arbitration provisions. Pet. App. 20-21. After Respondent signed, Petitioners gave her a separate five page, single-spaced standard form document that contained the arbitration provisions and other boilerplate.

REASONS FOR DENYING THE WRIT

I. THE PETITION IS NOTHING BUT AN UNWARRANTED JUDICIAL ATTACK

Using flawed analysis of Montana law, Petitioners invite this Court to look behind the opinion in *Alice P.*

Kloss v. Edward D. Jones & Co., and Paul Husted, 2002 MT 129, 310 Mont. 123, 54 P.3d 1, and to focus on the Montana Supreme Court's (hereinafter "MSC") supposed hostility toward arbitration. Petitioners charge that the MSC applied state law in a discriminatory manner. Petitioners claim that the MSC misused principles of adhesion contract and fiduciary duty to create a new requirement that consumers be given oral notice of arbitration agreements. Petitioners argue that the MSC was motivated by an historical antagonism to arbitration. Montana law does not support their unwarranted judicial attacks.

Kloss rests on rules generally applicable to adhesion contracts, fiduciaries and waivers of constitutional and procedural rights under Montana law. The MSC did not single out arbitration agreements to create a new requirement of oral notice.

The MSC, in the concurring opinion of Justice Nelson, (in which three other justices concurred), acknowledged the *Federal Arbitration Act* 9 U.S.C. § 2 (hereinafter "FAA"), but concluded that Montana law, generally applicable to contracts, mandates that waivers of constitutional rights – jury trial and access to the courts – must be proven to have been made voluntarily, knowingly and intelligently, and will be narrowly construed. The waiver must be shown to have been deliberately and understandingly made, and the language relied upon to constitute the waiver must unequivocally and unambiguously express the waiver of the right. Absent such proof, the arbitration clause will not be enforced. Pet. App. 34-36.

Kloss decided that the manner in which Petitioners sought to secure Respondent's assent did not provide fair

notice of the arbitration provisions contained in their standard form contract.

Acceptance of Petitioners' accusations would entangle this Court in another crisis of federalism. Petitioners misinterpret the FAA and seek to immunize arbitration agreements from generally applicable requirements of state law. The FAA does not require states to accord arbitration agreements preferential treatment.

A. *KLOSS* DID NOT CREATE NEW RULES SPECIFICALLY APPLICABLE TO ARBITRATION AGREEMENTS.

Petitioners miscast the decision of the MSC in an attempt to bring it within the rubric of this Court's holding in *Doctor's Assoc., Inc. v. Casarotto,* 517 U.S. 681 (1996). They claim that the MSC created a new rule requiring oral notice of arbitration agreements because of an historical hostility toward such agreements.

Petitioners argue that the MSC ignored Montana contract law and created new rules based on a subjective analysis of Respondent's actual expectations. Pet. at 14. They assert that if the MSC had applied basic principles of contract law, it never would have reached the question whether Respondent reasonably expected Petitioners' arbitration provisions, because those provisions were not ambiguous. Pet. 15. Disregarding the MSC's opinion, Petitioners claim that the "sole reason" the MSC found Petitioners' arbitration provision outside Respondent's reasonable expectations was because the MSC "was evaluating an arbitration provision." *Id.*

In truth, the MSC did not create new rules specifically applicable to arbitration agreements. Instead, the MSC explained that "in certain circumstances, traditional assumptions associated with contract law [do not apply]" to adhesion contracts. Pet. App. 11. For example, adhesion contracts are not necessarily enforced based on their plain language regardless of what a consumer knew or understood; otherwise, "reasonable expectations" would never become an issue unless the contract was ambiguous or uncertain. Pet. App. 14-15. The MSC has consistently held (regardless of the plain language of the agreement) that an adhesion contract will not be enforced against the weaker party when it is "not within the reasonable expectations of said party." Pet. App. 11, *Iwen v. U.S. West Direct,* 1999 MT 63, 293 Mont. 512, 977 P.2d 989; *Passage v. Prudential-Bache Securities, Inc.*, 223 Mont. 60, 66, 727 P.2d 1301-1302 (1986).

Petitioners rely on a line of cases that involves construction and interpretation of terms in insurance policies. In those cases, the MSC (and U.S. District Court in Montana) refused to apply adhesion contract rules (based on the weaker party's reasonable expectations) to interpret insurance policies. Pet. 14. The MSC instead applied the general law of contract interpretation. For example, in *Counterpoint, Inc. v. Essex Ins. Co.*, 291 Mont. 189, 967 P.2d 393 (1998), the MSC held:

> Because we conclude that Counterpoint's liability insurance policy is unambiguous, we enforce it as written. Despite Counterpoint's request that we apply the reasonable expectation doctrine and rules for interpreting an adhesion contract against the insurer, we do not apply these principles here. 967 P.2d 393 at § 18.

In *Shook v. State Farm Mut. Ins. Co.*, 872 F.Supp. 768, 773 (D.Mont. 1994), the U.S. District Court explained:

> One of the major concerns which led to the evolution of the "reasonable expectations" doctrine was a desire to protect an insured, unfamiliar with the technical terms utilized in most insurance policies, from having insurance coverage diluted by application of technical and confusing policy provisions. . . . A limited number of jurisdictions have extended the doctrine to all questions of insurance coverage, whether or not ambiguities exist in the language of the contract. . . . This extension, however, appears to be the minority view. . . . In the majority of jurisdictions, the doctrine has been utilized to resolve ambiguities in insurance policies in order that the policies comport with the insureds' "reasonable expectations". . . . Well established precedent indicates Montana follows the majority position.
>
> Construction of insurance contracts in Montana is governed by the general law of contract interpretation contained in Title 28, Chapter 3, Montana Code Annotated, and the case law which has developed thereunder in the context of insurance. The Montana Supreme Court has stated that the intention of the parties to the contract is not to be inquired into unless there is ambiguity on the face of the contract. Accordingly, where the language of an insurance policy admits of only one meaning, there is no basis for interpretation of the policy coverage under the guise of ambiguity. 872 F.Supp. 773 (citations omitted).

In *Kloss,* the issue was not the interpretation or construction of the arbitration provisions. The issue was

whether those provisions were unenforceable under adhesion contract principles. Specifically, the question was whether Respondent reasonably expected that Petitioners' standard form contract contained waivers of her constitutional and procedural rights.

Most courts now refer to this issue as "procedural unconscionability." See 1 *Corbin on Contracts* § 1.4 at 2 (2002 Fall Cumulative Supp., rev. ed.); 8 *Williston on Contracts* § 18.10 at 57-68 (4th ed. 1998); *Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal.4th 83, 113-114 (2001). Resolution of this issue involves consideration of all facts surrounding the formation of an adhesion contract to determine whether the weaker party had reasonable notice of the challenged provisions.[1] The analysis is not confined to a determination whether the written terms are ambiguous.[2]

In *Kloss,* the trial court (Judge Macek presiding) found that Respondent "signed [the detached card from the 1998 agreement] after being presented with documents by Donna Ferderer." Pet. App. 45, Finding #17. However, as noted to the contrary in the MSC concurring opinion of Justice Leaphart:

> I would also add that the record indicates that the detachable signature card was signed by Kloss before she was ever provided a copy of the Agreement. The branch office administrator,

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[1] See: 7 *Corbin on Contracts* § 29.9 at 405-408 and 413-415 (2002); *Kloss v. Polske Linie Lotnicze*, 133 F.3d 164, 169 (2nd Cir. 1997); *Mathews v. New Century Mortg. Corp.*, 85 F. Supp. 2d 874, 892 (S.D. Ohio 2002).

[2] *Id.*

> Donna Ferderer testified that she filled out the Jones account number, wrote the type of registration of the account and tore the detachable card out of the brochure. Ferderer testified that, "I gave it to Alice and told Alice I need her signature right here. . . . " Ferderer then took the form back, gave Kloss the disclosure statement, advised her that "these are the terms and conditions of opening up an Edward D. Jones account, keep these for your records. . . . "
>
> . . . Reasonable expectations are, by their very nature, prospective; they are defined *before* one enters into a contract, not after. Pet. App. 20-21 (emphasis is Justice Leaphart's).

Based upon Petitioners' procedure, Respondent understood that she was opening an account, but she was unaware of the arbitration provisions. The MSC considered the parties' relative bargaining positions[3] and nine year course of dealing in determining Respondent's reasonable expectations. Pet. App. 14 and Pet. 6-7.[4]

Over time, the parties understood that Respondent did not read Petitioners' form contracts and instead relied on Petitioners to explain important terms. *Id.* The MSC concluded that Petitioners' arbitration provisions were "important terms" because they included waivers of Respondent's constitutional and procedural rights. *Id.*

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[3] I.e., an elderly widow with a relative lack of sophistication and bargaining power. See: Pet. App. 3 and 23.

[4] Courts routinely consider a weaker party's course of dealing to determine whether adhesive terms were outside actual and reasonable expectations. See: *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 820-821 (1981).

Relying on the parties' course of dealing and relative bargaining strength, the MSC concluded that Respondent did not reasonably expect that Petitioners would require her to waive her constitutional and procedural rights without explanation.

Far from providing an explanation, Petitioners had Respondent sign a detachable signature card waiving her rights **before** presenting the arbitration provisions. Pet. App. 20-21. As Justice Leaphart's concurring opinion emphasized, reasonable expectations should be defined *before* one enters into a contract, *not after*. Pet. App. 21.

The cases relied upon by Petitioners demonstrate that the MSC does not apply adhesion contract law to the construction and interpretation of insurance policies. Pet. 14. None of those cases involved the issue decided in *Kloss:* whether an adhesion contract term was unenforceable because it was beyond the reasonable expectation of the weaker party. None of Petitioners' cases involve facts relating to the formation of the contracts remotely similar to the parties' course of dealing in *Kloss* – e.g., there was no indication that insurance brokers in those cases routinely explained important terms in their policies to new policyholders. Pet. App. 14.

At most, Petitioners have shown that the MSC, along with a majority of state courts, do not apply adhesion contract analysis to interpret insurance policies. It is not the purpose of the FAA, however, to have this Court ensure that Montana uniformly applies adhesion contract principles to the construction of insurance policies as well as to the enforcement of arbitration agreements, especially since insurance policies typically do not incorporate waivers of constitutional and procedural rights.

Most importantly, Petitioners have not established that the MSC applied Montana's law of adhesion contracts in a way that discriminated against Petitioners' arbitration agreement. Adhesion contract rules are generally applicable under the Montana commercial code. See *All State Leasing v. Top Hat Lounge*, 198 Mont. 1, 649 P.2d 1250 (1982). Indeed, in two prior cases, the MSC upheld arbitration provisions in stock brokers' form agreements against challenges under adhesion contract rules. *Passage, supra*, and *Chor v. Piper Jaffray & Hopwood*, 261 Mont. 143, 862 P.2d 26 (1993). And, in *Chor*, the MSC held that the arbitration provisions were clearly within a customer's actual expectations because she testified that she had reviewed and understood the contract. *Chor*, *supra*, at 261 Mont. 143, 149.

B. KLOSS PROPERLY APPLIED MONTANA LAW GOVERNING FIDUCIARY DUTIES THAT DID NOT DISCRIMINATE AGAINST PETITIONERS' ARBITRATION AGREEMENT.

Petitioners base their argument on a single, older case that is inapposite, *Brown v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 197 Mont. 1, 640 P.2d 453 (1982). The MSC held that Merrill, Lynch had no duty to bring a liquidation clause to an investor's attention. There was no contention that a fiduciary relationship was created when the customer agreement was formed. The facts surrounding contract negotiations were not even mentioned in *Brown*; hence, the MSC presumed the contract was an arm's length transaction. *Brown*'s only significance is that it contains a liquidation clause similar to Petitioners'.

The opinion in *Brown* is consistent with *Kloss*. *Kloss* does not hold that Petitioners had a duty to explain their liquidation clause. In *Kloss*, the MSC affirmed precedent that there was fiduciary duty in every broker customer relationship, and held that the scope of the duty in this case required Petitioners to explain the arbitration provisions based on the parties' prior course of dealing, and because Petitioners had discretion to buy and sell in Respondent's account. Pet. App. 17.

As fiduciaries, Petitioners should have explained the arbitration clause because it waived Respondent's constitutional and procedural rights. Pet. App. 18; 7 *Corbin on Contracts*, *supra*, at 412. The case relied upon by the MSC for finding a fiduciary relationship, *Chor, supra,* was decided eleven years after *Brown*. The fact that the MSC did not find a fiduciary duty in *Brown* when no party raised the issue is neither relevant nor a reason for finding *Kloss* ironic.

Petitioners' contention that the MSC created unique requirements for arbitration agreements by applying the law of fiduciary duty in this case is specious. Ten years ago, the MSC recognized that stock brokers could be fiduciaries if they have discretion to trade in a customer's account. *Chor, supra.* In *Kloss*, the MSC properly applied that principle because the parties' course of dealing supported it, not because the case involved an arbitration agreement.

II. *KLOSS* DOES NOT CONFLICT WITH THE FAA.

In *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*, 489 U.S. 468, 474

(1989), this Court held that one of the fundamental tenets of the FAA is that arbitration provisions should exist "upon the same footing" as all other contractual provisions. Evaluating arbitration agreements pursuant to federal law while evaluating all other contractual provisions pursuant to state law would place an arbitration provision on footing different from the rest of the contract; the arbitration provision would receive preferential treatment. See *Supak & Sons Mfg. Co. v. Pervel Indus., Inc.*, 593 F.2d 135, 137 (4th Cir. 1979). Arbitration provisions contained in adhesion contracts, like all other contractual provisions contained in adhesion contracts, are subject to the state's adhesion contract laws. See *Doctor's Assoc., Inc., supra*, at 687; *Chor, supra*, 261 Mont. at 148, 862 P.2d at 29; see also 9 U.S.C. § 2 (1998).

Petitioners argue that under the FAA, arbitration agreements may not be subject to general defenses under state law if those defenses turn on the fact that arbitration agreements necessarily entail waiver of constitutional and procedural rights. Pet. 21-22.

This argument directly conflicts with this Court's consistent holding that "generally applicable contract defenses, such as fraud, duress or unconscionability, may be applied to invalidate arbitration agreements without contravening [§ 2 of the FAA.]" *Doctor's Associates, supra*, at 687 citing *Allied-Bruce Terminix Co., Inc. v. Dobson*, 513 U.S. 265, 281 (1995); *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 483-84 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987). In *Allied-Bruce*, this Court stated that the FAA preempts state laws that are applicable "only to arbitration provisions." 513 U.S. 281. That is not the case

in *Kloss*, which applies "principles of Montana law generally applicable to all contracts." *Id.*, at 54 P.3d 1, 17 ¶ 76 (Pet. App. 36).

Secondly, Petitioners' argument rests on a false premise. Non-binding arbitration agreements do not require waiver of constitutional and procedural rights. Such waivers are not essential elements of all pre-dispute arbitration agreements. However, all contracts that contain such waivers are subject to strict scrutiny under Montana law, whether or not they require arbitration. *Id.*; *May v. Figgins*, 186 Mont. 383, 394, 507 P.2d 1132, 1138 (1980).

The Alabama Supreme Court's opinion in *Ex Parte McNaughton*, 728 So.2d 592 (Ala. 1998) is wrong. *McNaughton* held the *FAA* precludes state courts from invalidating arbitration agreements as unconscionable because they involve waivers of constitutional and procedural rights. *McNaughton* held that such an approach would assign a suspect status to arbitration agreements in violation of the *FAA*. Pet. 21-22. The employment contract in *McNaughton* required employees to arbitrate their claims while allowing the employer to retain its judicial options.

In *Armendariz v. Foundation Health Foundation Psychcare Services, Inc., supra*, the California Supreme Court rejected *McNaughton*'s notion that requiring mutuality in an adhesive arbitration contract imposes a suspect status on arbitration agreements. *Armendariz*, 24 Cal. 4th 119-120. The Court stated:

> . . . it does not disfavor arbitration to hold that an employer may not impose a system of arbitration on an employee that seeks to maximize the

> advantages and minimize the disadvantages of arbitration for itself at the employee's expense. Id., 24 Cal. 4th at 120.

In other words, arbitration agreements are not necessarily unilateral.

Kloss did not impose a suspect status on arbitration agreements per se. It requires a stronger party to give fair notice if it knows that a weaker party does not reasonably expect that she is waiving constitutional and procedural rights. It requires a fiduciary to give fair notice if he is requiring another with whom he is in a relationship of trust to waive her constitutional and procedural rights. These principles apply to all adhesion and fiduciary contracts seeking certain waivers whether or not they require arbitration. The MSC did not invalidate the contract provisions in *Kloss* because they required arbitration. The recent decision of the Ninth Circuit in *Ting v. AT&T*, docket no. 15416 (9th Cir. Slip Op. 2/11/03), makes the pertintent point at footnote 16:

> If the district court indicated any hostility, it was not directed at arbitration, but at the manner in which it was forced upon consumers . . . The decision is hostile to the adhesive and oppressive nature of [the agreement] not to the particular forum . . . More importantly, the Supreme Court's general statements on arbitration do not override the FAA's particular rule which obtains here and is well settled: "Generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening [9 U.S.C.A.] § 2". *See Doctor's Assoc.* [*supra*].

Similarly, the MSC invalidated the Petitioners' contract because the circumstances under which Petitioners tried to secure Respondent's assent did not provide her reasonable notice of the arbitration provisions, i.e., it was "beyond her reasonable expectations" and not because of hostility to arbitration. Pet. App. 20-21, 23-24 and 32-33.

III. *KLOSS* DOES NOT RAISE ISSUES OF NATIONAL IMPORT.

Kloss rests on the particular facts surrounding the parties' nine year course of dealing and Petitioners' peculiar practice of having Alice Kloss sign an agreement before presenting the agreement to her. It does not apply generally to pre-dispute arbitration agreements, whether or not those agreements call for binding arbitration. It does not purport to affect fiduciary relationships outside Montana. Therefore, it does not apply generally to broker accounts outside Montana.

A. *GREEN TREE* HAS NO RELATION TO *KLOSS*.

Petitioners assert, without explanation, that in deciding *Green Tree Financial Corp v. Bazzle,* docket no. 02-634 (cert. granted 1/10/03), this Court is likely to address issues relevant to their petition. Pet. 27-29. Petitioners claim that their petition requires this Court to decide whether state courts have the power to substitute their notions of fairness in protecting constitutional rights at the expense of the parties' arbitration agreement. Pet. 28. That is untrue.

The issue is whether state courts have the power to refuse to enforce arbitration agreements under state laws

of general application. This Court has consistently held that they do. *Green Tree* does not involve that issue, but rather whether arbitration is applicable in class actions.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

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